Personal Financial Management - Lesson 9
Investments/Savings/Thrift Savings Plan/REDUX

ENABLING OBJECTIVES:

Upon completion of this lesson, students will be able to:

9.1 Describe advantages and disadvantages of different types of savings/investment instruments (passbook savings, certificates of deposit, dollar cost averaging, tangible assets, IRAs, mutual funds, bonds and TSP)
- 9.1.1 Identify the advantages of each type of savings/investment instrument
- 9.1.2 Identify the disadvantages of each type of savings/investment instrument
- 9.1.3 Identify the tax impact of each type of savings/investment instrument

9.2 Describe the TSP Program
- 9.2.1 Describe each TSP fund
- 9.2.2 Define how each fund works
- 9.2.3 Explain where to go to sign up for TSP

9.3 Describe how time and interest work to the benefit of the small investor
- 9.3.1 Identify software that will show long term affects of monthly deposits on savings

9.4 Explain 3 techniques of savings and investing

9.5 Identify 4 methods to reduce discretionary spending and provide more money for savings

9.6 Describe the difference between savings and investing and what tools are used to accomplish each one

9.7 Explain the benefits of having an IRA
- 9.7.1 Identify the different types of IRAs
- 9.7.2 Explain how to start an IRA
- 9.7.3 Explain how an IRA may enhance your financial future

9.8 Identify various financial resources and their availability for assistance or self-study (Must include the Navy/Marine Corps Relief Society and the Navy Mutual Aid Society)

REFERENCES:

1. OPNAVINST 1740.5 (Personal Financial Management Education, Training and Counseling Program)
2. U.S. Navy's Personal Financial Management Standardized Curriculum (PERS 662)
3. OPNAVINST 1740.1 Fleet and Family Support Center Program
4. Command Financial Specialist Training Manual NAVPERS 15608C

SLIDES:

9-1	Lesson 9 Title Slide
9-2	Today's Retirement Concept
9-3	Sources of Retirement Income
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9-5	Types of Retirement Plans
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9-20 Investment Assets
9-21 Investment Instruments
9-22 Rule of 72
9-23 Techniques of Saving and Investing
9-24 Creative Savings Strategies
9-25 Sources of Assistance
9-26 Summary Questions
9-27 Summary
9-28 Effects of Compound Interest

CASE STUDIES:
None

VIDEO TAPES:
None

NOTES TO THE FACILITATOR:
The main points of this topic are:
$ Sources of Retirement Income
$ Navy Retirement Plans
$ Thrift Savings Plan
$ Comparison of Investment Options

I. INTRODUCTION

SHOW SLIDE 9-1 INVESTMENTS/SAVINGS/THRIFT SAVINGS PLAN/REDUX

During this lesson we are going to talk about several things related to your retirement - not just retirement from the Navy. The subject of retirement merits our discussion and your attention because the concept of retirement is much different now than it probably was when your parents, and certainly your grandparents were your age.

A. Today's concept of retirement has changed significantly from the past. Many people spend 20, 30, or even more years retired. They retire younger, live longer, and are usually quite healthy. As a result, retirees not only live independently, but also enjoy more of the fruits of their labors. This means that retirement income may need to equal or, depending on activities, even exceed pre-retirement income.

SHOW SLIDE 9-2 TODAY'S RETIREMENT CONCEPT

II. SOURCES OF RETIREMENT INCOME

SHOW SLIDE 9-3 SOURCES OF RETIREMENT INCOME

Retirement income is often described as a three-legged stool, with the legs being Social Security benefits, retirement and/or pension payments, and investment income. Let's look at how you should approach each of these.

A. Social Security. Social Security began in 1935, at a time when most employers did not provide any sort of retirement benefits. The law was titled the Federal Insurance Contributions Act; therefore, it is the F-I-C-A withholding you see on your leave and earnings statements. Sailors do pay FICA tax.

SHOW SLIDE 9-4 SOCIAL SECURITY

1. Persons your age will be eligible to draw full Social Security benefits beginning at age 67. It will probably be about a thousand dollars a month or less in terms of today's dollars.	**CLICK FOR BULLET**
2. After you have been working for a year or two, you should ensure the Social Security Administration is tracking your employment by requesting an Earnings and Benefits Estimate. The Agency has begun a policy of periodic notifications, but it's a good idea for you to check from time to time throughout your working life.	**CLICK FOR BULLET**

B. Retirement Benefits and Pensions. Some of you may retire from the military, begin a second career, and retire from it. Others of you may leave the service prior to retirement and become employed in the civilian world. In either case, I strongly suggest you examine potential employer's retirement plans and pension benefits when deciding to take, or remain in, any specific job. For today, you are in the military, and we will concentrate on military retirement benefits. There are two types of retirement plans, and today, the military has both types.

SHOW SLIDE 9-5 TYPES OF RETIREMENT PLANS

1. Defined Benefit Plans are the more traditional type. They are funded by the employer, and one must usually work a relatively long time to become eligible for a pension check. The amount of monthly pension is normally based on salary and the number of years worked, and is guaranteed for life. These plans may or may not include cost of living increases. (Military retirement does.)

SHOW SLIDE 9-6 DEFINED BENEFIT PLANS

2. Defined Contribution Plans have become increasingly popular over the last 20 years or so. These plans allow employees to contribute up to a certain amount of their salary each month, before taxes, to a fund that they have a significant amount of control over. Sometimes, frequently in the civilian world, employers will match a portion of each month's contributions. The most common are 401(k) plans, named after the regulating paragraph in the Federal Income Tax Code. There is no guarantee with this type of plan. Workers eventually receive a lump sum payout, which they can then invest for future income. These sums can be quite large; however, the amount depends on how much the worker has invested, and the earning of the specific investment plan.

SHOW SLIDE 9-7 DEFINED CONTRIBUTION PLANS

C. Currently, there are two different military Defined Benefits retirement systems in effect that you can choose from.

SHOW SLIDE 9-8 MILITARY RETIREMENT PLANS

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1. The “High Three” Plan became effective on 9 September 1980. There is 2.5% per year multiplier factor and COLAs. This is the only retirement option for those who entered service after 9 September 1980.

SHOW SLIDE 9-9 HIGH THREE PLAN

2. The REDUX plan stands for "reduced multiplier," and substantially reduces the value of military retirement. Note that this plan will NOT apply to you, unless you opt for it, plus a one-time cash payment as I will explain shortly. Under REDUX, the multiplier factor was reduced from 2.5% per year to 2% per year for the first 20 years of service and increased to 3.5% per year for each subsequent year – up to a total of 30 years of service. This means that anyone retiring under REDUX with 20 years of service would get 40% of High Three base pay, vice 50% under the High Three plan. Those staying for 30 years would end up with the same 75% multiplier as under the High Three plan. However, another feature of REDUX is equally, perhaps more, detrimental than the multiplier adjustment. This is the reduction in annual COLAs to CPI <u>minus</u> 1%, with a one-time "catch up" at age 62. These two features combined would add up to about a 25% reduction in the value of retired pay for someone retiring with between 20 and 22 years of service - about a quarter of a million dollars over the average life span.

SHOW SLIDE 9-10 REDUX PLAN

3. By the late 1990's, Soldiers, Sailors, and Airmen were "voting with their feet" on the REDUX retirement plan and leaving the services *en masse*. In an attempt to rectify recruiting and retention problems, the Military Manpower Reform Act of 1999 placed all service members back under the High Three retirement plan, BUT allowed them the option to receive a Career Status Bonus (CSB) of $30,000 at their 15-year point and take retirement under the REDUX system. This option is known as CSB/REDUX.

SHOW SLIDE 9-11 CSB/REDUX PLAN

a. All of you will have many years to consider which option, CSB/REDUX or High Three, will be best for you. The official position on the DoD web site is shown on the slide. That doesn't appear to be much help, so let's look at a few pros and cons of the CSB/REDUX.

SHOW SLIDE 9-12 DOD POSITION ON CSB/REDUX

b. For starters, if you take the bonus, it is fully taxable – unless you take advantage of a savings plan I'll tell you about shortly. If you are an E-6 by this time, with a working spouse, you will likely be in the 25% tax bracket, and your $30,000 bonus becomes $21,600. Also be advised that should you take the bonus and leave the service prior to 20 years, you must repay a proportional share of the bonus. Granted, you could invest the bonus. However, even an 11% return, which is at the high end of what could be expected for even experienced investors, would leave the average retiree with less than 25 years service short of what he or she would have had under the High Three plan. You might even think that using the bonus to pay for children's education, or pay off debts would be beneficial, but there are far less costly approaches to these issues. Lastly, this program is so new that courts have not yet decided how a bonus may be handled in regards to a former spouse from whom you were divorced prior to receipt of the bonus. In summary, this will be a serious decision with far-reaching consequences. Get sound advice and think clearly when making it.

SHOW SLIDE 9-13 CSB/REDUX CONSIDERATIONS

D. I hope you remember that all the retirement plans we just talked about fall in the category of Defined Benefit Plans. Up until now, this was the only type plan available to service members. However, beginning October 9, 2001, in addition to your Defined Benefits Plan, you and all other service members will have access to a Defined Contributions Plan. This plan, known as the Thrift Savings Plan or T-S-P, has been available as part of Civil Service retirement for a number of years. Let's look at how it works and what it can do for you.

SHOW SLIDE 9-14 TYPES OF RETIREMENT PLANS

1. The Thrift Savings Plan will have an enrollment period from October 9th through December 8th of this year. You may contribute up to 7% of your base pay and up to 100% of any special pays or bonuses up to the IRS maximum, currently $10,500 per year. The important thing to note is that money contributed to TSP is NOT counted as taxable income for the year in which it is contributed. You will eventually have to pay taxes on this money, and on the money it earns, but for now it is TAX FREE. At the current time, there is no employer match from Uncle Sam for your contributions, although this could change in the future. Your contributions belong to you. There are some options available for borrowing funds while on active duty. However, thee are substantial penalties for withdrawing money prior to age 59 and 1/2.

SHOW SLIDE 9-15 THRIFT SAVINGS PLAN (TSP)

2. I mentioned that money contributed to the Thrift Savings Plan is your money, and that you have control over it. This control is exercised by directing which of five funds your money is invested in. The “C” fund will basically track performance of the stock market. The “F” fund will invest in corporate and Government bonds, and is therefore unlikely to actually lose money. The “G” fund will invest in Government securities and is guaranteed against any loss. The “I” fund that invests entirely in non-U.S. companies, and the “S” fund, investing in small to medium size U.S. companies, are fairly new. Their performance will be directly proportional to the success of the companies in which they invest. We will discuss the concept of investing and associated risk in a few minutes. For now, suffice it to say that the fund you choose will be determined by the return you desire, balanced with the risk you can afford.

SHOW SLIDE 9-16 TSP INVESTMENT OPTIONS

3. Upon separation or retirement, you will have three options for your money in the TSP. You can leave your money in the TSP; take the entire amount, minus tax withholding, in a lump sum, or transfer the entire amount to a new employer’s 401(k) plan or to your personal IRA.

SHOW SLIDE 9-17 TSP DISBURSEMENT OPTIONS

E. Recall that the third leg of our retirement planning stool is investment income. There are several differences between investing money and merely saving it. We already discussed three types of savings funds, but recognize that the ultimate purpose of saving money is to eventually spend it. Conversely, the purpose of investing money is to have it make more money. Investing is generally thought of in terms of a significant time span, five years or more. Even optimum savings instruments have limited ability to overcome the effects of inflation and taxes, both of which decrease the value of our money. Wise investments will mitigate these effects. Savings accounts are virtually 100% safe, as most are insured by the Federal Government. Investing, on the other hand, involves some degree of risk. However, the greatest risk is not making prudent investments, and therefore not growing your money to meet your retirement needs. Because saving and investing have different purposes, different instruments are used for each.

SHOW SLIDE 9-18 SAVING VS. INVESTING

1. Savings instruments include regular or share savings accounts, certificates of deposit (a different kind of CD than most of you probably think of), money market accounts, and U.S. savings bonds. All are highly safe, and liquid, but provide relatively low yields.

SHOW SLIDE 9-19 SAVINGS INSTRUMENTS

2. Investment instruments fall into one of two categories: equity or debt. With equity assets, you invest as an owner; with debt assets, you invest as a lender. Equity assets are subdivided into "growing assets," normally stocks of publicly traded companies, and "hard assets," such as precious metals, real estate, or collectibles. The primary debt assets are bonds, which are actually IOUs issued by companies and varying levels of Government.

SHOW SLIDE 9-20 INVESTMENT ASSETS

3. So with all these options, it's logical for you to ask which you should invest in. And the clear, unequivocal answer is, "It depends." Actually, it does depend on the time span and the time period of your investment. Historically, over the last 70 years, stock market investments have returned an average of 10% to 12%, while bond returns have averaged 4% to 7%. However, you should recognize that there are years, and periods of several years, where bonds significantly out-performed stocks. One way to cover both bases is to invest in mutual funds. These funds pool money from investors with similar goals and invest in a variety of stocks and bonds, thereby providing the security of diversity. Of course, a small percentage of your money goes to pay the professional fund managers.

SHOW SLIDE 9-21 INVESTMENT INSTRUMENTS

4. One easy way to determine the affect of any particular return on an investment is to use the Rule of 72. To apply the Rule, divide 72 by the expected annual percent of return on your investment. The answer will be the number of years it will take for your investment to double at the expected rate of return. For example, if you earn 7.2% on your investment, it will take 10 years to double your money. If you earn 10%, you will double your money in 7.2 years. If you can earn a 15% annual return, your money will double every 4.8 years.

SHOW SLIDE 9-22 RULE OF 72

F. No matter how you choose to invest your money, there are three proven techniques that will assist you in accumulating the funds necessary for savings and investment.

1. The first, which is a sound rule to live by, is "Pay yourself first." Develop a spending plan that reduces debt and provides a positive cash flow, but in doing so "pay yourself first." Set aside a certain amount for savings and investment at the top of your plan; don't relegate savings to "whatever is left over." Savings allotments and contributions to the TSP are two excellent ways to "pay yourself first." You never miss the money because you never see it.

SHOW SLIDE 9-23 TECHNIQUES OF SAVING AND INVESTING

2. The second very worthwhile technique is to maximize tax-deferred investment opportunities. The TSP and civilian 401(k) plans are excellent vehicles for this purpose. Individual Retirement Accounts, or IRAs, are another. Types of IRAs, eligibility requirements, and specific tax advantages are too complex to cover in the time allotted for this class; however, they are fully explained in your handout materials.

CLICK FOR BULLET

3. The third technique is known as dollar cost averaging. This is accomplished by contributing a set amount to your investment accounts each month. The effect is to dampen out short-term market fluctuations.

CLICK FOR BULLET

4. Some of you may be saying this is all well and good, but where do you get the money to save and invest? Let's look at a few things you can do.

SHOW SLIDE 9-24 CREATIVE SAVINGS STRATEGIES

   a. One way to quickly pad a savings account is to shift debt payments to savings when the debt is paid off. If you have been paying 20, 40, or 50 dollars a month on a washing machine, just start banking this amount when the loan is paid.

b. If you unexpectedly receive a sum of money, say a birthday check from a family member or a tax refund, put it directly into your savings account and watch it grow.	**CLICK FOR BULLET**
c. Select one month during the year and really be a Scrooge. Obviously, you must continue to pay your bills, but be very consensus of every dollar you spend. It won't seem like you are putting a major crimp in your lifestyle if you are only doing it for a month, and along the way you may well develop some excellent habits that will carry over into the future.	**CLICK FOR BULLET**
d. Be very aware of just how much you spend on fast food and snacks. It's real easy to spend $2.50 on such items each work day. That could be $50 a month going into your savings and investment accounts.	**CLICK FOR BULLET**
e. When living off-base, see how much you can cut back on utilities for one month. Little things like turning off lights when leaving a room, turning up the air conditioner when you leave for work, and waiting until you have a full load to run dish and clothes washers can easily save you 10% - 20% on your utility bill. Put the difference in savings!	**CLICK FOR BULLET**

IV. SOURCES OF ASSISTANCE

Your handout materials contain many sources you may call on for assistance as you plan for your retirement. The one specific web site listed on the chart is a good place to start, as it provides an interactive worksheet that will help you determine how much income you will need during your retirement years. There are many other sources, most of which are available at the base library. Be a little leery of commercial web sites, as they may be designed to guide you to specific investments. I fully understand that retirement looks a long, long way off to most of you right now, and therefore retirement planning may not be very high on your priority list. All I can do to counter this is tell you that it will get here one day, as it has for so many before you. Unfortunately, I know many people who reached an age where they would like to have retired, but failed to have the resources necessary to do so. These people didn't plan to fail, they simply failed to plan. Don't become one of them!

SHOW SLIDE 9-25 SOURCES OF ASSISTANCE

SHOW SLIDE 9-26 SUMMARY QUESTIONS

Note to Facilitator

Ask the following questions:

1. Name three sources of retirement income
2. What are two benefits to participating in TSP?
3. What is the difference between savings and investing?
4. Name three types of investments?
5. Where can we go for assistance?

V. SUMMARY

SHOW SLIDE 9-27 SUMMARY

Ladies and gentlemen, we covered a lot of very important information during this hour. We started by looking at how the concept of retirement has changed in just a few short years. We then examined the three-legged stool of retirement income. We talked about Navy retirement systems, with particular emphasis on those that will affect you, and about which you may one day have to make a very important decision. We discussed the Thrift Savings Plan, a new benefit that can significantly assist you in saving for your retirement years. We examined the differences between saving and investing and talked about why each is important. We examined various vehicles you may use to invest for your future and discussed proven techniques that will assist you in forming sound financial habits. Lastly, we briefly touched on sources that are available to assist you in this important task. Your handout materials contain a lot of information we could not cover in class. I strongly urge you to read this material, and to start right now to plan for what I hope will be a long, active, and financially secure retirement.

SHOW SLIDE 9-28 EFFECTS OF COMPOUND INTEREST